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Pa

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In the Supreme Court of the United States

OCTOBER TERM, 1950

No. 516

ELWIN S. BENTLEY, E. MERRITT ASHWORTH AND LEROY P. BROWNELL, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 192-205) is reported at 14 T.C. 228. The *per curiam* opinion of the Court of Appeals (R. 220) is reported at 184 F. 2d 668.

JURISDICTION

The judgment of the Court of Appeals was entered October 31, 1950. (R. 221.) The petition for a writ of certiorari was filed January 25, 1951. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

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QUESTION PRESENTED

Whether the Court of Appeals erred in affirming the Tax Court's determination that taxpayers, not their wives, were the real owners and partners of a business controlled and operated by taxpayers as "employees" of their wives, and that therefore the portions of the business profits attributed to and reported by the wives were includible in taxpayers' gross incomes as defined in Section 22(a) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, *infra*.

STATEMENT

The facts as found by the Tax Court (R. 193-204) may be summarized as follows:

From 1939 until 1944 taxpayers Brownell, Ashworth and Bentley (hereafter sometimes called the husbands), and the wife of one of them (Mrs. Brownell), were the stockholders of Hoosick Engineering Company, Inc., which manufactured and sold automobile parts. Brownell and his wife together owned 362 shares of stock, Ashworth also owned 362 shares, and Bentley owned 105 shares. The business was managed by taxpayers, who possessed the technical skill and knowledge essential to its successful operation. The business sustained a slight loss during the first year of its operation but thereafter enjoyed increasing profits until 1943, when its net income amounted to $41,858.

(R. 193-195, 202.) For the 1945 and 1946 fiscal years the net income amounted to $51,008 and $78,328, respectively. (R. 195.)

In 1944 taxpayers decided to sell or liquidate the business because of their dissatisfaction with the amount of profits left after taxes. Their tax counsel suggested a plan whereby taxpayers' wives would form a partnership and employ taxpayers to operate the business. (R. 196, 202.) The plan was devised for the sole purpose of minimizing taxes. (R. 203.) Pursuant to the plan the corporation was dissolved, and a partnership of the same name, consisting of taxpayers' wives, was contemporaneously formed. (R. 196.) On the same day the three wives addressed an offer to the husband-stockholders, which the latter accepted, as follows (R. 196-197):

> 1. We will rent from you the use of your good name, and goodwill, and your leasehold rights (subject to the rents payable thereunder) for an annual rental beginning November 1, 1944 of Three Dollars ($3.00), being One Dollar ($1.00) per annum for each of the above named assets.
>
> 2. We will rent your equipment from you at an annual rate of six (6%) per cent of the cost thereof to you in the liquidation of the Hoosick Engineering Company, Inc., and we will agree in addition thereto, to maintain it in good condition, and to make at our expense all necessary, proper, and reasonable repairs and replacements to the end that we will deliver

back to you this plant in as good condition as received from you, less depreciation, which we shall describe as ordinary wear and tear. When we say "plant" we mean all of the equipment that you took over on the liquidation of the Hoosick Engineering Co., Inc.

3. We agree to pay the rent upon the property which you have under lease.

4. We will take over your accounts receivable, inventories and work-in-process at the price at which those assets came over to you from the Hoosick Engineering Co., Inc., in its liquidation and agree to pay you for the same.

5. We will take over all orders on the books, and all the business that the Hoosick Engineering Co., Inc., distributed to you, if any there be.

6. We agree to continue the Hoosick Engineering Co., Inc., Pension and Profit-Sharing Plan as our own.

In consideration of the foregoing we agree to pay you, in return for services rendered, annual salaries during the life of this agreement as follows: to Mr. LeRoy P. Brownell of $7500.00, to Mr. E. Merritt Ashworth $7500.00, and to Mr. Elwin S. Bentley $3500.00, and we promise to pay you as agreed in Paragraphs 1, 2 and 4 above.

The formation of the partnership composed of the wives was recorded with the state and county authorities. (R. 198.)

The arrangement produced no substantial change in the policies or operations of the business.

The wives knew nothing about the business or its operations, except what their husbands told them, and were completely lacking in the skills or abilities necessary to carry on the business. They had nothing to do with the management of the business other than to sign checks, and they signed whatever checks were presented to them without exception. The husbands had no power to sign checks but continued as before to control the business and to perform the identical duties they had theretofore performed as officers of the corporation. Their salaries from the partnership were approximately the same as those theretofore paid by the corporation, and generally in proportion to the former family stock interests in the corporation. For the second fiscal year of the partnership (ended August 31, 1946) their compensation was increased under a "management contract" so as to include a percentage of the profits, divisible in proportion to their salaries. Ashworth and Brownell each received $11,000 as "salary" plus $13,593 additional compensation under the "management contract", while Bentley received $3,550 as "salary" plus $3,965 additional compensation under the "management contract". (R. 197-199, 202-203.)

When the corporation was dissolved its balance sheet showed gross assets of $68,975, liabilities of $9,548, depreciation reserve of $17,162, and a net worth of $42,264. (R. 198.) The accounts receiv-

able and inventory which the wives agreed to "take over" from the husband-stockholders (R. 197) totalled $36,764; these receivables were collected and the inventory was liquidated within two years, and the proceeds paid over to the former stockholders. (R. 198.) The business had no borrowed funds and its capital requirements were small. (R. 199.) However, as part of the arrangement, Mrs. Brownell and Mrs. Ashworth each contributed $2,000 and Mrs. Bentley contributed $580. These amounts were fixed in accordance with the former family stockholdings in the corporation, and the business profits were made distributable to the wives in the same proportions. (R. 197-198, 202.)

For the first fiscal year of the partnership (9 months ending August 31, 1945) its net income amounted to $51,008, and for the second year to $78,328. All of this net income was distributed to and kept by the wives, and also reported by them for income tax purposes. (R. 198.) The husbands reported the salaries and the additional compensation received by them under the management contract. (R. 199.) The Commissioner determined that the amounts reported by the wives were includible in the gross incomes of their respective husbands. (R. 193.) The Tax Court held that the husbands earned the income which their wives reported and were the true owners and partners of the business. Accordingly, it sustained the Com-

missioner's determination. (R. 202-204.) The Court of Appeals affirmed *per curiam.* (R. 220.)

ARGUMENT

1. The decision below is in accord with the established principle that an anticipatory assignment of income, whatever its formal cloak, is ineffective taxwise. The principle applies whether the income in question is derived from services (*Lucas* v. *Earl,* 281 U.S. 111; *Helvering* v. *Eubank,* 311 U.S. 122), or from property (*Commissioner* v. *Sunnen,* 333 U.S. 591; *Harrison* v. *Schaffner,* 312 U.S. 579; *Helvering* v. *Horst,* 311 U.S. 112; *Helvering* v. *Clifford,* 309 U.S. 331), or from a blend of both sources (*Commissioner* v. *Tower,* 327 U.S. 280; *Lusthaus* v. *Commissioner,* 327 U.S. 293; *Commissioner* v. *Culbertson,* 337 U.S. 733). Where as here we are dealing with intra-family transactions, "special scrutiny of the arrangement is necessary" (*Helvering* v. *Clifford, supra,* p. 335), lest the tax incidence be shifted by "surface changes of ownership" (*Commissioner* v. *Culbertson, supra,* p. 746).

The Tax Court concluded (R. 202-204) that the instant arrangement, though couched in the form of a rental of the taxpayer-husbands' business assets to a partnership formed by their respective wives and the contemporaneous employment of the husbands by their wives to run the business, was in reality but an assignment to the wives of a portion of the future business profits earned by the hus-

bands; in short, that the husbands remained the true owners and partners of the business nominally carried on by the wives. The Tax Court's decision is abundantly supported by the record, and was correctly affirmed by the court below.

Pursuant to a plan proposed by their tax counsel, and for the sole purpose of reducing taxes, the husbands dissolved a corporation of which they were the stockholders and officers, and their wives contemporaneously purported to create a partnership to carry on the business. (R. 196, 202-203.) The husbands and wives then entered into an agreement, which had no fixed duration, whereby the wives purported to "rent" and "take over" the business assets from their husbands. (R. 196-197.) They also agreed to pay the husbands a salary plus a percentage of the profits under a "management contract", in proportion to the husbands' former stockholdings, the remaining profits to be divided among the wives in the same proportion. (R. 197-199, 202-203.) Although the wives contributed some capital of their own, its amount was small, a total of $4,580 in relation to a business having a net worth of about $42,000 (R. 198) and annual profits for the tax years in suit of over $50,000 (R. 195). Moreover, no new capital was needed. (R. 199.) The arrangement produced no substantial change in the policies or operations of the business. The husbands, who possessed the requisite skill and knowledge for carrying

on the business, continued as before to manage and control it. The wives knew nothing about the business. They furnished no services other than the formal signing of checks, and without exception they signed whatever checks were presented to them. The husbands never relinquished title to the business assets, nor control over their use, and the arrangement was terminable at will. Its only practical effect was to channel part of the business profits to the wives, and its sole objective was tax avoidance. (R. 199-200, 202-204.) To accord tax effect to the arrangement would exalt artifice above reality.[1]

2. The decision below does not, as taxpayers assert (Pet. 9-12), conflict with *Henson* v. *Commissioner,* 174 F. 2d 846 (C.A. 5th), or *Ginsburg* v. *Arnold* (C.A. 5th), decided December 21, 1950 (1951 C.C.H., par. 9108). In the *Henson* case, the court pointed out (p. 847) that the husband had "irrevocably divested himself of all legal title, right, interest, and control over the business." Here, on the other hand, the husbands retained both legal title to the business assets and full control over conduct of the business. (R. 202-203.) In the *Ginsburg* case, involving a claimed partner-

[1] The unreality of the arrangement is accentuated by the fact that within the first two years of the partnership the wives received (and reported) about $130,000 of profits in return for nothing more than their agreement to "rent" the plant and equipment and "take over" the accounts receivable and inventory, and for a small capital contribution ($4,580) which was not needed. (R. 196-198.)

ship between taxpayer and his children, the court noted that there was "no finding by the court below that they did not in good faith intend to join together as partners". Here, on the other hand, the Tax Court found (R. 203) that "the purpose of the wives' partnership was not the creation or operation of a joint enterprise", but solely "that of minimizing income taxes". The decisions of the Fifth Circuit Court of Appeals in the *Henson* and *Ginsburg* cases are to be compared with those of the same court in other family partnership cases, in which it affirmed the Tax Court's refusal to recognize the partnership for tax purposes, and in which this court denied certiorari.[2] There is no more occasion for further review of this case than of those cases.

Nor is the decision below in conflict with *Commissioner* v. *Culbertson,* 337 U. S. 733, as taxpayer alleges. (Pet. 9-11.) This Court there stressed (pp. 741-743) that whether a family partnership is entitled to tax recognition presents a question of fact in each case, depending upon the intention of the parties, no single factor being conclusive. Both courts below have found against

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[2] See, *e.g.*, *Scherf* v. *Commissioner,* 161 F. 2d 495, certiorari denied, 332 U.S. 810; *Belcher* v. *Commissioner,* 162 F. 2d 974, certiorari denied, 332 U.S. 824; *Mead* v. *Commissioner,* 131 F. 2d 323, certiorari denied, 318 U.S. 777; *Argo* v. *Commissioner,* 150 F. 2d 67, certiorari denied, 326 U.S. 762; *Sewell's Estate* v. *Commissioner,* 151 F. 2d 806, certiorari denied, 327 U.S. 805; *Sewell* v. *Commissioner,* 151 F. 2d 765, certiorari denied, 327 U.S. 783; *Morton* v. *Thomas,* 158 F. 2d 574, certiorari denied, 330 U.S. 834.

the taxpayer on this factual issue. Since their concurrent findings are not clearly erroneous the case presents no occasion for issuance of the writ. *Cf. United States* v. *O'Donnell,* 303 U. S. 501; *Goodyear Co.* v. *Ray-O-Vac Co.,* 321 U. S. 275, 278; *Virginian Ry.* v. *Federation,* 300 U. S. 515, 542; *Baumgartner* v. *United States,* 322 U. S. 665.

CONCLUSION

The decision below is correct. There is no conflict, and no occasion for further review. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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FEBRUARY, 1951

APPENDIX

Internal Revenue Code:

SEC. 11. NORMAL TAX ON INDIVIDUALS.

There shall be levied, collected, and paid for each taxable year upon the net income of every individual a * * * tax * * *.

(26 U.S.C. 1946 ed., Sec. 11.)

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

(26 U.S.C. 1946 ed., Sec. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b).

(26 U.S.C. 1946 ed., Sec. 182.)

SEC. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * * *

(2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

* * * * *

(26 U.S.C. 1946 ed., Sec. 3797.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

> Sec. 29.22(a)-1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22(b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined. * * *.

* * * * *

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No. 516.

IN THE

Supreme Court of the United States

October Term, 1950.

ELWIN S. BENTLEY, E. MERRITT ASHWORTH AND LEROY P. BROWNELL, *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE.

REPLY TO BRIEF OF RESPONDENT IN OPPOSITION.

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REPLY TO BRIEF OF RESPONDENT IN OPPOSITION.

The brief of the respondent does not fairly state the case. The petitioners regret the necessity of calling the Court's attention to this fact.

On page 8, the respondent says:

> "* * * the husbands dissolved the corporation of which they were the stockholders and officers * * *."

This is a misstatement of a material fact.

The men owned a little over 87% of the corporation and one of the women owned a little over 12% of it.

It is respectfully suggested that there is no theory of law on which this woman can be ousted of her 12% ownership no matter what the correct rule in this case may be. She

always owned 12%. No one has a right to take it away from her. To conceal, in the argument, the fact that one of the women always owned 12% of the corporation is to mislead the Court.

Yet all through the respondent's brief, he pretends that the men owned the entire corporation.

On page 8, the respondent says that the net worth of the liquidated corporation was $42,000; and on page 9 he says:

> "* * * The husbands never relinquished title to the business assets * * *"

That is not true. The true facts are:

> (a) the men never had title to the business assets, for they owned only 87% of them; one of these women owned 12% of them; and
>
> (b) $36,764.08 of these $42,000 net assets were sold to these women on November 28, 1944, the day the corporation went out of business; title passed to them that day (Ex. 13; R. 92), and they paid for these assets in money over a period of fourteen months (R. 92).

It is no excuse for disguising this fact, to say that the women "took over" the assets and "collected them." That is a specious play upon words. It is submitted that "to take over and pay for" is to "buy." The books of account show a sale (Ex. 13). The women bought the assets, took title to them, and paid for them, just as is done in any business transaction.

Respondent, on page 3 of his brief, has omitted the fact that the corporation lost money in 1944, the year it liquidated.

Respondent insists the plan was one of tax avoidance, when it was not such a plan. The evidence clearly shows it was a business plan. The finding of the Tax Court that this was a tax avoidance plan is not supported by any evidence.

Respondent belittles the fact that the women were the record partners, put up the working capital from their own funds earned and saved by them, controlled the partnership finances, and drew and kept all the profits.

The statement of earnings by the corporation, and the later statement of earnings by the partnership (page 3 of respondent's brief) are not fairly compared, for the former are stated *after* salaries and the latter *before* salaries. The Tax Court made this same mistake.

Much is made of the fact that *after it had been decided to liquidate the corporation* counsel came forward with a plan to sell the business, which plan worked out successfully. There is no fault in salvaging a business, and nothing reprehensible in employing counsel capable of suggesting a plan that salvaged a dying business.

Respectfully submitted,

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